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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
P. O. Box 15196
San Diego 15, California

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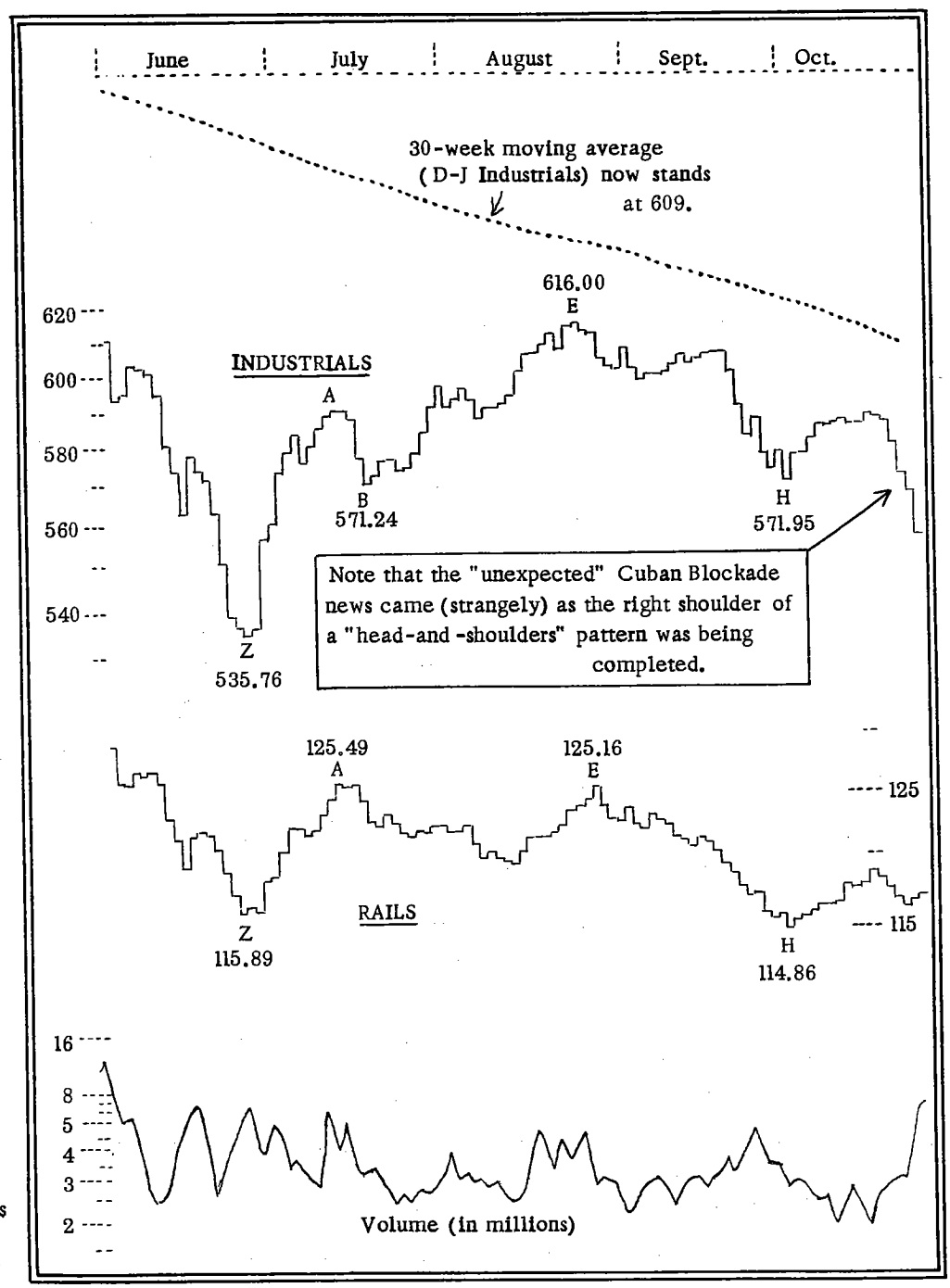
THE MARKET The special interim Letter (197) drew attention to the possibility of triple-divergence between Industrials and the advance-decline ratio. Whether or not such divergence was fated to occur, the "blockade" news from Washington served to drive the market lower before a classic triple-divergence pattern could be completed. Is it a constructive "straw in the wind" that the market broke before a triple-divergence pattern could be completed? As far as I am concerned, it is not. Recent Letters have repeatedly emphasized the importance of the 571.24 (Industrial) level. On October 22 the 571.24 level was penetrated on the most authoritative (5.6 million shares) kind of volume.

In general, bear markets are easier to "read" than bull markets. So far, this bear market has been no exception. While many Wall Streeters were drawing "bullish conclusions" based on the short interest, the odd-lot studies (and these are usually interpreted incorrectly), the odd-lot shorts, contrary opinion ("there are too many bears around") and a number of other special and even "secret" indicators, it seems to me that the price movement and volume were telling the true story.

Volume goes with the primary trend. In a bear market, volume tends to expand with lower prices while rallies that go dull can be considered normal selling spots. Letter 196 discussed the progressive contraction of volume on each of the rallies from the June 26 bear market lows. The implications of dullness following the July-August rally and following the most recent September-October rally could hardly be construed as bullish. The great Russian writer Dostoevsky once wrote: "Be simple and rediscover the world." Perhaps we might apply this thought to the market and say, "Don't be too sophisticated -- accept the implications of volume and the price movement and 'rediscover' the primary trend."



Perhaps 80% of all stockholders tend to think of major price movements in terms of special news, manipulation, government decrees and Presidential wishes. The majority is either ignorant of or incapable of grasping the concept of the all-powerful primary trend.

For this reason, when shocking news such as the Cuban blockade hits the headlines, I am besieged with calls and letters asking whether "this is a new bull market" or whether "this changes the primary trend." A primary bull or bear market may be temporarily extended by a war or an act of God, but the primary trend cannot be manipulated. The tidal force of the market continues until the best (in a bull market) or the worst (in a bear market) is fully discounted in the price structure.

Robert Rhea once wrote that he found that "the first response of the market to unexpected news is usually the reverse of the direction which prices will soon travel." As this is written, the Industrials are within three or four points of their Friday close. This amounts to "calmness" in the face of scare news. The Rails, Steels and "War Babies" have pushed up, but the rallies have been less than spectacular (in the past Rails have jumped 10% in a few days on real war news). My personal opinion is (1) that the second reaction of the market will be the correct one, and (2) that the second reaction will probably be bearish (as against the initial calm reaction).

VOLUME A subscriber writes to ask why recent Letters "have contained so much about volume in the market and in individual stocks." Volume acts differently during bull and bear markets, and I have attempted to point this out in preceding and following paragraphs. Moreover, it seems to me that volume has been a key to all the recent price weakness, and as such it deserves further discussion now.

Everybody mouths platitudes about volume, but few understand it or have taken the trouble to study it. Dow made passing references to volume in his editorials. For instance, in May, 1901, Dow wrote: "Great activity means great movement whenever the normal balance between buyers and sellers is violently disturbed." In January of that year Dow wrote: "Dullness usually runs into advance in a bull period and into decline in a bear period."

Hamilton in his earliest studies ignored volume, and he believed that the price movement alone discounted everything -- including volume. In January, 1911, (Wall St. Journal) Hamilton wrote "We prefer to neglect volume and the character of trading in these studies, believing that the Average itself makes allowances for these factors."

But a month later Hamilton wrote : "The market became dull on small reaction, showing increasing activity on any resumption of the advance. As any professional knows, this is a good indication that strength is still on the buying side."

Two months later (April) he said, "So far as volume is concerned, we prefer to neglect it." Yet at the end of that month Hamilton wrote: "Perhaps the weakest feature of the market was that it tended to become more active on declines."

The fact is that Hamilton paid more and more attention to volume as the years passed. In his famous "Turn of the Tide" editorial written October 26, 1929, Hamilton wrote that following the extreme peak "there were at least four rallies in the course of the decline in the Industrials, and each of these was weaker than the last. Dow always considered this a danger signal." By "weaker," Hamilton was referring to diminishing volume.

Robert Rhea was much more consistent than Hamilton regarding volume implications, and he seldom penned a Letter without referring to volume of transactions. "It is well known," wrote Rhea in 1934, "that penetration accomplished with velocity and increasing volume is a more potent indication than when the signal is otherwise given." A few years earlier Rhea had written: "When a secondary rally has occurred in a bear market, with activity dying out after the advance, it is reasonable to conclude that the market is overbought and that a further downward trend is near if a tendency towards increased activity is noticeable on declines."

H. M. Gartley (writing during the '30's) was one of the greatest technicians of his time. Gartley did more work on volume than any man before or since. In 1933 Gartley wrote: "Note that bear market cycles begin on reduced volume. As the major (downward) phase develops, volume increases and this phase ends in a selling climax on heavy volume. The ensuing rally (corrective phase) is accompanied by declining volume, which dwindles until the rally loses momentum completely, and the major trend is resumed in a new bear cycle.

"In bull markets, cycles of accumulation (bottoms) begin out of dullness, and the advance (major phase) continues until an over-bought condition (always accompanied by substantial turnover) culminates the rise. The heaviest volume usually appears during the final markup preceding the actual top. The ensuing decline (corrective phase) frequently begins in a sharp sell-off accompanied by a large increase in volume."

Again for bear markets Gartley wrote: "Bear market rallies start out of active selling climaxes. Note that the first six bear rallies following the 1929 top came out of heavy trading. But the rally in July, 1932, came out of extreme dullness, indicative of a major reversal (a new bull market began on July 8, 1932)".

During primary bear trends a few factors must be kept in mind in relation to volume: (1) Values are constantly decreasing

during a bear market. Each passing month means further deterioration in intrinsic values. Following a rally in a bear market there often appears a period of dullness and/or the formation of a narrow range in the Averages (a "line"). With values declining, the odds always favor such situations' being resolved on the downside. In other words, time favors the downside during a primary bear trend. (2) In a bear market (even more obviously than in a bull market) volume tends to go with the primary trend. Thus, most rallies in a bear market end with a burst of volume and then dullness--or simply dullness alone. If, following the dullness, the Averages turn down on increasing volume, the odds favor a resumption of the primary bear trend.

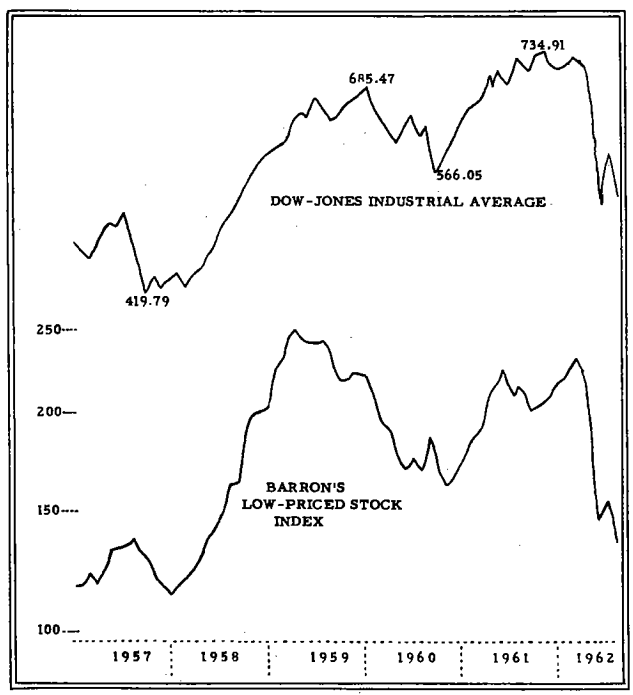
In the current situation it is important to remember that the March-June collapse ended on heavy volume. The rally from the June lows would therefore seem to correspond with Gartley's statement that "bear market rallies start out of active selling climaxes" rather than areas of dull volume and exhaustion.

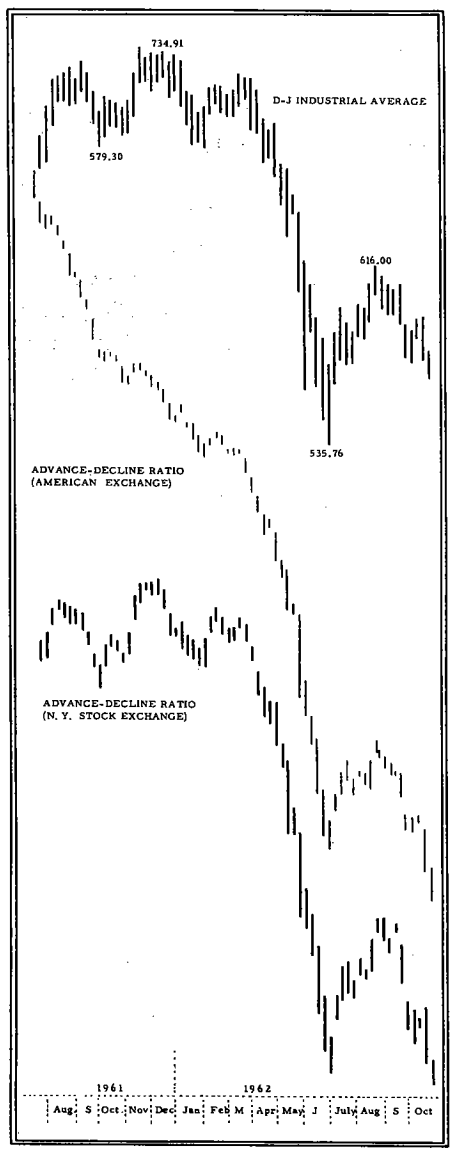
Furthermore, volume has tended to diminish on each successive upthrust since the July 12 recovery peak (see Letter 196, page 1). The August 23 recovery high of 616.00 (Industrials) was accompanied by less volume than the July 12 peak, and the most recent rally was notable for its extreme dullness.

Since August 23, volume has tended to contract on advancing days and increase on declining days. Such action suggests a slow but persistent resumption of the primary bear trend. This tendency of volume to decrease on rallies and increase on declines has been a fundamental and obviously bearish characteristic of all the market action of the past three weeks.

THE SINKING "WATER LEVEL" Letter 189 used the simile of a "leaking bathtub" to illustrate the action of the majority of stocks during a primary bear market. The tendency of most issues during a bear market is to sink to lower levels. During intermediate corrections (against the primary trend) we may see the Industrial Average rally sharply, but during such periods the majority of issues usually confirm with weak or short-lived advances. For this reason, diversified long positons during bear market corrections generally prove singularly unprofitable. The correction which began on June 26, 1962, has been no exception.

In view of the above, I have urged subscribers to sell all holdings and refrain from buying until we have some reasonable evidence to suggest that the primary trend is turning bullish again. The action of the market over the last ten days provided dramatic evidence to illustrate the thesis that "the bathtub is still leaking". On October 18 the advance-decline ratio on the speculative American Exchange dropped to a new bear market low (see chart). On October 22 the advance-decline ration on the N.Y. Exchange also broke to a bear market low. The week ending October 19 saw Barron's Low-Priced Stock Index break below its June low-- thereby setting a new low since 1958.





In early October the Rail Average broke below its June low, thereby establishing a new low for the entire bear market. The only major price index which has not broken to new bear market lows during the past few weeks is the D-J Industrial Average. The action of the A-D ratios on both exchanges strongly suggests that t he primary bear trend is continuing. All in all the current market picture is anything but hopeful: nevertheless, according to Dow's classic Theory it will take an Industrial penetration of the June (535.76) low to reconfirm the existence of the primary bear market.

Note: A particularly interesting feature of the past few weeks has been the sharp and almost unabated drop in the D-J Utility Average. In bear markets (contrary to popular belief, Utilities go with the rest of the issues).

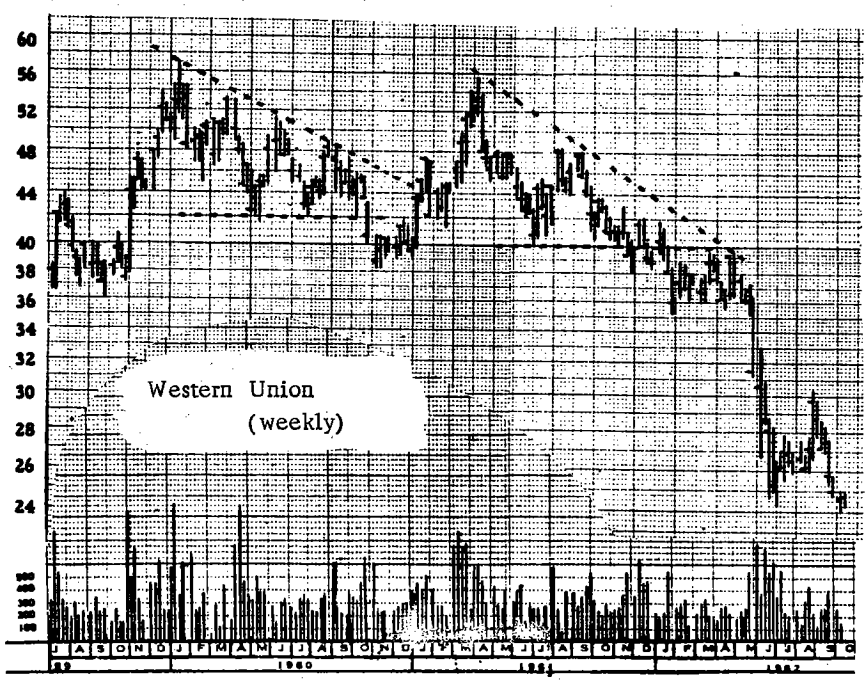
LATE MARKET NOTES (Written Tuesday, October 23, after the close). The "second reaction" to shocking news (mentioned on page 2) seems to have gripped the market this afternoon. Today Industrials closed down 10.58, Rails up 33¢, Utilities down 3.89 (1) on volume of 6.1 million shares. Aside from the forthcoming (normal bear market) contraction in earnings, the implications of the Cuban blockade now hang over us. These implications cannot be fully understood now-- they may not be known a month from now. This means that investors face continuing major uncertainty-- a situation which the market abhors. With Rails having provided their half of a bearish signal and with Industrials having smashed the 571.24 level, the single point of importance becomes the Industrial bear market low of 571.24. If this point is broken on increasing volume, the market will have reconfirmed the primary bear trend--and primary bear leg number three will be well underway.

NOTE: Traders Research is now putting out a quarterly book showing daily price action and volume of all N.Y.S.E. stocks (together with 50 charts of averages, group averages, relative strength charts, etc.). The book will be $60.00 per year or $20.00 per single copy, and it is an excellent value--all charts are logarithmic . (There is no commission arrangement between this service and Traders Research or any other organization). Write Traders Research, 4604 Gravois Street, St. Louis 16, Missouri.

STOCKS Of 346 representative stocks, 20 are now holding above their 30-week moving average. The bullish percentage remains distressingly low.

Occasionally a stock will form a bullish or bearish pattern, but instead of carrying out the implications of that pattern, it will suddenly reverse and move with the general market (particularly if the market enters a violent move which is opposite that in which the individual stock is headed). A good example is Western Union (see chart). During most of 1960 WU formed a very large descending triangle. Such formations are made up of successive rallies, but each rally terminates below the last. Finally, all the supply within the triangle is distributed and the stock breaks below its support (the support for the descending triangle in WU in 1960 was at 42).

In late 1960 WU broke below its support at 42, dropping below 39. Then to the chagrin of those of us who were short, the stock reversed violently and followed the general market up during 1961. WU formed a perfect "double top" at the 56 level, following which a second large descending triangle began forming (during 1961 and 1962). The fundamentals had not changed, but the general market had saved the WU during 1960 and'61. The base of the second descending triangle was 40. That base was cracked in late 1961, following which the stock hung for a few months, then fell apart during the 1962 crash.



Moral: Do not disregard bearish formations in individual stocks. In time, the majority of them are carried out.

Recent Letters have listed many stocks for shorting. In a majority of cases, these stocks are now showing fair to sizable profits. If you have not put out shorts by now, it appears to me that you would be "chasing them" at this juncture. Subscribers should try to reduce their bearishness (from a trading standpoint) as a move gets well underway. Short profits should always be protected with mental buy orders.